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IN THE

Supreme Court of the United States

OCTOBER TERM, 1960.

No. ~~1009~~ 140

NEW JERSEY AUTOMOBILE CLUB,
Petitioner,

vs.

~~COMMISSIONER OF INTERNAL REVENUE~~ UNITED STATES,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS.

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No.

NEW JERSEY AUTOMOBILE CLUB,

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS.

New Jersey Automobile Club prays that a writ of certiorari issue to review the judgment of the United States Court of Claims entered in this case on March 2, 1960.

Opinions Below.

The opinion of the United States Court of Claims, entered March 2, 1960, has not yet been printed in the official reports. However, the opinion of the Court is printed in Appendix B hereto, infra, pp. 18 to 27.

The opinion of the United States Court of Claims, in a companion case, *American Automobile Association* v. *United States*, and entered March 2, 1960, has not yet been printed in the official reports. However, the Court's opinion is printed in Appendix B hereto, infra, pp. 28 to 35.

Jurisdiction.

The jurisdiction of this court is invoked under 28 U. S. C., Section 1255 (1).

Questions Presented.

Two separate questions are presented for review:

I. Under the Internal Revenue Code of 1939, as amended, does the claim of right doctrine apply to prepaid membership dues?

II. Does the claim of right doctrine, as applied to prepaid membership dues, violate the 16th Amendment to the Constitution of the United States?

Statutes Involved.

The pertinent statutory provisions are printed in Appendix A, infra, pp. 12 to 17.

Statement.

The facts are not in dispute and are the same for both questions. Petitioner, an automobile club rendering various services to its members, kept its books on a calendar year basis and upon the accrual method of accounting. Its chief source of revenue was from membership dues, which were received by petitioner in every month of the year. A member paid his dues, not for past services rendered, but for services to be rendered to him by petitioner during the 12-month period following the payment of the dues. Under petitioner's accrual method of accounting, petitioner maintained a record of membership dues received in a "dues" account as a liability in the taxpayer's general ledger. At the end of each tax year taxpayer closed this account and transferred part of the balance in it to another liability account, called a "Reserve for Members" account. The method of establishing this reserve was to pro-rate one-twelfth of the annual dues received to each month of the service membership. Petitioner filed its income tax returns in accordance with its books. The Commissioner contended that under the "claim of right" doctrine the dues were income for tax purposes when received rather than when earned. The Court of Claims dismissed petitioner's petition on the basis of *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. 180. It is petitioner's contention that the claim of right doctrine, as a matter of law, does not give the Commissioner the right to change petitioner's method of accounting, or to tax membership dues paid in advance as income when received.

Reasons for Granting the Writ.

I. On the question, under the Revenue Code of 1939 as amended, of whether membership dues constituted income to petitioner when received or when earned:

A. This important question should be resolved by the United States Supreme Court.

The Supreme Court found it unnecessary to determine whether the claim of right doctrine applied in the case of *Michigan Automobile Club* v. *Commissioner* because petitioner's pro-rata allocation was "arbitrary." Here, the first question raised by the pleadings is whether the Commissioner can rely on the claim of right doctrine as his authority to change petitioner's method of accounting. This is solely a question of law. If the doctrine applies there need be no query as to whether petitioner's method of accounting clearly reflected income.

The majority opinion in *Michigan Automobile Club* v. *Commissioner* was joined in by five of the nine Justices. Mr. Justice Wittaker took no part in the case, and Justices Burton and Clark joined in that portion of the dissenting opinion by Mr. Justice Harlan which disagreed with the majority on the ground that the majority should have rejected, rather than by-passed, the Commissioner's "claim of right" argument. Therefore, it cannot fairly be argued that any one of the nine Justices of the Supreme Court has supported the Commissioner in his use of the "claim of right" doctrine as the reason for failing to apply the principles of accrual accounting. Only three Justices have

spoken and they have indicated their disapproval of this use of "claim of right". This important question should be resolved if further litigation is to be minimized in the lower and appellate courts.

B. There is a direct conflict among Circuits.

The decision of the Court of Claims on the membership dues issue is in direct conflict with the decision of the Court of Appeals for the Tenth Circuit in *Beacon Publishing Company* v. *Commissioner* (1955), 218 Fed. (2d) 697, and with the decision of the Court of Appeals for the Fifth Circuit in *Schuessler et al,* v. *Commissioner,* 230 Fed. 2nd 722.

In the *Beacon Publishing Company* case, the single question presented was whether prepaid newspaper subscriptions should be included in the taxpayer's income for the year in which they were received, or be spread over the subscription period. The publishing company kept its books and filed its income tax returns on the accrual basis of accounting and prepaid subscriptions were credited to a liability account entitled "Prepaid Subscriptions" and included in income only as the subscriptions were earned. It was conceded that the taxpayer received the prepaid subscriptions without restrictions as to their use.

The commissioner claimed the prepaid subscriptions were income for the year in which received, just a he contends in petitioner's case that prepaid membership dues were income when received. The Tax Court, in sustaining the Commissioner in *Beacon Publishing Company* (1954), 21 T. C. 610, cited its decision *Automobile Club of Michigan,* 20 T. C. 1033 as a precedent for taxing prepaid income for the year when received.

The Tenth Circuit Court of Appeals reversed and held that prepaid income received by an accrual basis taxpayer constitutes income only as the expenses of earning that income are incurred. The Tenth Circuit Court of Appeals pointed out that the "claim of right" doctrine, relied upon by the Commissioner and the Tax Court, as enunciated by this Court in such cases as *North American Oil Consolidated* v. *Burnet*, 286 U. S. 417; *United States* v. *Lewis*, 340 U. S. 590, and *Healy* v. *Commissioner*, 345 U. S. 278, has no application to such a case of prepaid income. The "Claim of right" cases previously presented to this Court have not involved a case like *Beacon Publishing Company*, or like petitioner's case, where prepaid income is received in one year, without any dispute as to the ownership of the funds, and the expenses of earning that income are incurred in a subsequent year.

In the *Schuessler* case the taxpayer sold gas furnaces with a guarantee that he would turn the furnaces on and off each year for five years. He kept his books on the accrual method and as furnaces were sold he set up a reserve, which he deducted on his income tax returns, to cover the cost of the service over the five-year period. The Tax Court (*E. W. Schuessler*, 24 T. C. 247) disallowed the deduction and stated:

> "This is essentially the same problem as the reporting of prepaid income in the year in which received for services to be performed in following years. The petitioner in fact, on brief, recognizes that the two problems are identical and cites Beacon Publishing Company *v.* Commissioner, 218 Fed. (2d) 697 (C. A. 10, 1955), in support of his argument that the reserve here in issue was a proper deduction in computing his income for 1946."

The Tax Court simply declined to follow the decision of the Tenth Circuit Court of Appeals in the *Beacon* case. The Fifth Circuit, in reversing the Tax Court, stated:

> "We prefer the reasoning as well as the conclusion reached by the Court (in the Beacon case) in the Tenth Circuit. There the opinion correctly, we think, disposed of the 'claim of right' theory advanced by the Commissioner and adopted by the Tax Court in this type of case."

In its opinion, the Fifth Circuit Court of Appeals also relied on the decision of the Ninth Circuit Court of Appeals in *Pacific Grape Products Co.* v. *Commissioner* (1955), 219 Fed. (2d) 862. In that case the taxpayer, engaged in the fruit canning business, kept its books on the accrual basis and reported income from sales in the year it billed its buyers and took as a deduction the estimated cost of labeling and preparing the goods for shipment and brokerage fees to be paid the following years. The Tax Court disallowed the deduction for the estimated expenses, but the Court of Appeals reversed, saying:

> "Not only do we have here a system of accounting which for years has been adopted and carried into effect by substantially all members of a large industry, but the system is one which appeals to us as so much in line with plain common sense that we are at a loss to understand what could have prompted the Commissioner to disapprove it. Contrary to his suggestion the petitioner's method did not reflect its true income it seems to us that the alterations demanded by the Commissioner would wholly distort that income."

A decision of this Court is needed to eliminate discrimination and insure uniformity of the tax treatment of prepaid income.

C. The Tax Court is creating more confusion on this issue.

The Tax Court has taken the position that regardless of whether or not a taxpayer's method of accounting clearly reflects income, the application of the claim of right doctrine must prevail. It has been reversed by the courts of appeals having jurisdiction of the review proceedings in the following cases: *Paul Harrold*, 16 T. C. 134, 192 Fed. 1002 (C. A. 4, 1951); *Pacific Grape Products Company*, 17 T. C. 1097, 219 Fed. 2nd 862 (C. A. 9); *Beacon Publishing Company*, 21 T. C. 610; *E. W. Schuessler*, 24 T. C. 247; *Henry Hilinski*, 14 T. C. M. 659, 237 Fed. 2nd 703; *Bressner Radio, Inc.*, 28 T. C. 378, 267 Fed. 2nd 520, and *Denise Coal Company*, 29 T. C. 528, 271 Fed. 2nd 930.

Each of the above seven cases have been decided by the Court of Appeals for seven different circuits.

The Tax Court judges joined in a reviewed opinion, written by the Chief Judge, that the Tax Court, being "a court of national jurisdiction to avoid confusion should follow its own honest beliefs until the Supreme Court decides the point." (*Arthur L. Lawrence*, 27 T. C. 713 (1957), at pages 716-720, reversed per curiam, 258 Fed. 2nd 562 (C. A. 9).)

Since the higher courts in a majority of the circuits have reversed the tax court on this issue, it is apparent that the Supreme Court should review this important question if further extensive litigation is to be minimized.

II. On the question whether the claim of right doctrine, as applied to prepaid membership dues, violates the 16th Amendment to the Constitution of the United States:

A. An important question of Constitutional law is presented which has not been, but should be, settled by this Court.

If this Court resolves that the claim of right doctrine does not apply to prepaid membership dues in the statutory sense, then this question becomes moot. However, if this Court holds that the doctrine is applicable in the statutory sense or that petitioner's proration of membership dues to income was artificial or arbitrary, then the constitutional question is a very vital one.

Under the doctrine of the claim of right, the Commissioner recomputed plaintiff's income for each year by treating membership dues as income *the instant* the dues were received. Such dues were received under individual contracts providing for performance for one year and plaintiff subsequently incurred substantial costs and expenses in the performance of such contracts. Petitioner urged that the taxing of such receipts as income is unconstitutional, as in violation of the Sixteenth Amendment.

The construction of any income tax act is inseparable from the interpretation of the Sixteenth Amendment. No income can be reached by any income tax act even though Congress expressly declared it to be taxable as income, unless it is in fact income.

If membership dues paid in advance are not income within the meaning of the Constitution, they are not income within the intent of the Internal Revenue Code.

The above distinction is well recognized and was reiterated as recently as 1954 as shown by Senate Committee report #1622, page 168, 83rd Cong., 2nd Sess., relating to Section 61 (a), as follows:

> "Section 61 (a) provides that gross income includes 'all income from whatever source derived.' This definition is based upon the 16th amendment and the word 'income' is used as in section 22 (a) in its constitutional sense. It is not intended to change the concept of income that obtains under section 22 (a)."

Respondent assumes that a mere receipt under a contract creates income as such and that the liability to perform must be entirely disregarded for this purpose. He disregards an express obligation created under the sanctity of a contract.

In *Doyle* v. *Mitchell* (1918), 247 U. S. 179, the Court said:

> "Yet it is plain, we think, that by the true intent and meaning of the Act the entire proceeds of a mere conversion of capital assets were not to be treated as income."

It is clear from this decision that the determination of "income" must always involve a deduction from the gross revenues of all the costs, including all expenses of bringing those gross revenues into the business. Gross receipts are not synonymous with gross income.

In *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, the Court said:

> "We must reject in this case, as we have rejected in cases arising under Corporation Excise Tax Act

of 1909 the broad contention submitted in behalf of the government that all receipts—everything that comes in—are income within the proper definition of the term 'gross income' * * *"

Conclusion.

This Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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APPENDIX A.

Constitution of the United States.

Article I, Section 2, clause 3.

Representatives and direct Taxes shall be apportioned among the several states which may be included within this Union, according to their respective Numbers, which shall be determined by adding to the whole Number of free Persons, • • •

Article I, Section 8, clause 1.

The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States; • • •

Article I, Section 9, clause 4.

No Capitation, or other direct, Tax shall be laid, unless in Proportion to the census or Enumeration herein before directed to be taken.

Amendment 16.

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Internal Revenue Code of 1939, as Amended.

Sec. 21. Net Income.

(a) Definition.—"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

Appendix A—Statute.

Sec. 22. Gross Income.

(a) General Definition—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. • • •

Sec. 41. General Rule.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. • • •

Sec. 42. Period in Which Items of Gross Income Included.

(a) General Rule—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under Section 41, any such amounts are to be properly accounted for as of a different period. • • •

Sec. 43. Period for Which Deductions and Credits Taken.

"The deductions and credits (other than the corporation dividend paid credit provided in Section 27) provided for in this chapter shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred', dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *"

Sec. 48. Definitions.

* * * * * *

(c) "Paid or Incurred", "Paid or Accrued".—The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.

Sec. 101. The following organizations shall be exempt from taxation under this chapter—

* * * * * *

Regulation 111.

Sec. 29.21-1. Meaning of net income.—The tax imposed by chapter 1 is upon income. Neither income exempted by statute or fundamental law, nor expenses incurred in connection therewith, other than interest, enter into the computation of net income as defined by section 21. (See section 24 (a) (5).) In the computation of the tax various classes of income must be considered:

(a) Income (in the broad sense), meaning all wealth which flows in to the taxpayer other than as a mere return of capital. It includes the forms of income specifically described as gains and profits, including gains derived from the sale or other disposition of capital assets. Cash receipts alone do not always accurately reflect income, for

the Internal Revenue Code recognizes as income-determining factors other items, among which are inventories, accounts receivable, property exhaustion, and accounts payable for expenses incurred. (See sections 22, 23, 24, and 117.)

(b) Gross income, meaning income (in the broad sense) less income which is by statutory provision or otherwise exempt from the tax imposed by chapter 1. (See section 22.)

(c) Net income, meaning gross income less statutory deductions. The statutory deductions are in general, though not exclusively, expenditures, other than capital expenditures, connected with the production of income. (See sections 23 and 24.)

(d) Net income less credits. (See sections 25, 26, 27, and 28.) * * *

Sec. 29.22(a)-1. What included in gross income.—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. * * *

Sec. 29.22(b)-1. Exemptions—Exclusions from gross income.—Certain items of income specified in section 22(b) are exempt from tax and may be excluded from gross income. These items, however, are exempt only to the extent and in the amount specified. No other items are exempt from gross income except (1) those items of income which are, under the Constitution, not taxable by the Federal Government; (2) those items of income which are exempt

from tax on income under the provisions of any Act of Congress still in effect; and (3) the income exempted under the provisions of section 116. • • •

Sec. 29.41-1. Computation of Net Income. Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise, properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See sections 29.42-1 to 29.42-3 inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

Sec. 29.41-2. Bases of computation and changes in accounting methods—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer; and deductions taken accordingly, unless in order clearly to reflect income such

amounts are to be properly accounted for as of a different period.

Sec. 29.41-3. Method of Accounting. It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. * * *

Sec. 29.42-1. When included in gross income.—(a) In general.—Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. * * * If no determination of compensation is had until the completion of the services, the amount received is ordinarily income for the taxable year of its determination, if the return is rendered on the accrual basis; or, for the taxable year in which received, if the return is rendered on the receipts and disbursements basis. * * *

Sec. 29.43-1. "Paid or incurred" and "paid or accrued"—(a) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48 (c).) The deductions and credits provided for in chapter 1 (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred" unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. * * *

APPENDIX B.

Opinion Below.

New Jersey Automobile Club v. *The United States.*

U. S. Court of Claims, No. 274-54, 3/2/60.

OPINION

JONES, Chief Judge, delivered the opinion of the court: The plaintiff, an accrual basis taxpayer, seeks to recover alleged overpayments of its Federal income taxes for the years 1947, 1948 and 1949. The initial issue concerns the taxpayer's claim of exemption from taxation under ¶ 101(10) of the Internal Revenue Code of 1939. The alternative issue involves the tax treatment of prepaid annual membership dues.

The organization and the functions of the taxpayer are substantially similar to other automobile clubs which have recently been involved in this same type of litigation. It is incorporated under the laws of the State of New Jersey as a nonprofit organization without capital or shares. Under its charter with the American Automobile Association (AAA), the taxpayer's memberships are limited to three counties in New Jersey. The taxpayer's primary activities consist of rendering services to its members. Members are entitled to emergency road service, trip planning, tour books, hotel directories and related travel services, arrangements for shipments of cars abroad, bail bond service, and a personal accident insurance policy. The taxpayer also engages in activities designed to promote the safety and convenience of motorists.

[*Law*]

We are confronted at the outset with the taxpayer's claim of exemption from Federal income taxation under

§ 101(10) of the Internal Revenue Code of 1939. Section 101(10) provides for exemption from taxation of

> "Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or *like organizations;* but only if 85 per centum or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses. [Italics supplied.]"

The taxpayer urges that it is a "like organization." Its reasoning may be summarized as follows: The three types of organizations enumerated in § 101(10)—a life insurance association, a ditch company, and a telephone company—have nothing in common. However, they are all bound together by the word "benevolent" in the first instance and by the words "mutual" and "cooperative" in the second and third instances. The taxpayer concludes that the court must look to this common denominator of these three relative noncomparables. Should the court take this tack, so the argument runs, it would follow that organizations having the characteristics of *mutuality* or *cooperation* are "like organizations" and are therefore exempt.

We cannot agree with this interpretation of the statute. Our approach to the problem must of course be guided by the rule that a claim for exemption from Federal taxation must be clearly made out. *Atlantic Coast Line R. R.* v. *United States*, 66 C. Cls. 378, 401 (1928). "Taxes being the sole means by which sovereignties can maintain their existence, any claim on the part of any one to be exempt from the full payment of his share of taxes in any portion of his property must on that account be clearly defined and founded upon plain language." *Bank of Commerce* v. *Tennessee*, 161 U. S. 134, 146 (1896).

If subsection (10) of § 101 is viewed, not in isolation, but (as we think it should be) in the context of the other subsections of § 101, the fallacy in the taxpayer's argument becomes readily apparent. The purpose of § 101 was to enumerate, in separate subsections, certain specific organizations which shall be exempt from taxation. This listing contains many organizations possessing the same common denominator (mutuality and cooperation) which the taxpayer attributes to the organizations enumerated in subsection (10). If the court is to hold that the Congress intended to exempt certain organizations under subsection (10) solely because they possess characteristics which are also common to many of the organizations listed elsewhere in § 101, it must necessarily gloss over the obvious fact that the Congress—despite the common characteristics of mutuality and cooperation—carefully spelled out these various exempt organizations in separate subsections. This we are unable to do.

On the contrary, we think that in subsection (10) the Congress intended to exempt organizations which were like "benevolent life insurance associations of a purely local character," or like "mutual ditch or irrigation companies," or like "mutual or cooperative telephone companies," and not merely organizations which were like the distilled essence of these three relative noncomparables.[1]

The taxpayer's additional argument that its function is like or similar to that of the three organizations spelled out in subsection (10) suffers from the same basic fallacy. Even if we agree with the taxpayer that these mutual companies all provide services of a commercial nature to members, not for profit, but for their common good, we are still faced with the fact that this functional characteristic is common to many of the organizations listed elsewhere in

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[1] Cf. *Chattanooga Automobile Club* v. *Commissioner*, 182 F. 2d 551, 554 (6th Cir. 1950) [50-1 U. S. T. C. ¶ 93351].

§ 101. Cf. *Keystone Automobile Club* v. *Commissioner*, 181 F. 2d 402, 405 (3d Cir. 1950) [50-1 U. S. T. C. ¶ 9266].

Moreover, an automobile club is too well known and too important for us to presume that the Congress would set forth in detail a variety of specific organizations entitled to exemption under the 19 subsections of § 101 and intend that an automobile club should be included in the general expression "like organizations" contained in subsection (10).

[*Not Exempt*]

Accordingly, we hold that the taxpayer is not exempt from Federal income taxation under § 101(10).[2]

We turn now to the alternative issue raised by the taxpayer—the tax treatment of the prepaid income of an accrual basis taxpayer. The problem arises because membership dues are paid to the taxpayer for one year in advance. The dues upon collection are commingled with all other cash receipts and deposits in its general bank account. The record of membership dues received, however, was maintained in a "dues" account as a liability in the taxpayer's general ledger. At the end of each tax year the taxpayer closed this account and transferred part of the balance in it to another liability account, called a "reserve for members" account.

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[2] The plaintiff, prior to oral argument, withdrew its claim for exemption under § 101(9) and § 101(7). Cf. *American Automobile Assn.* v. *Commissioner*, 19 T. C. 1146 [Dec. 19,537] (claim for exemption as a business league under § 101(7)); *Chattanooga Automobile Club* v. *Commissioner*, 12 T. C. 967 [Dec. 17,021], aff'd 182 F. 2d 551 (6th Cir. 1950) [50-1 U. S. T. C. ¶ 9335] (claim for exemption under § 101(7) and § 101(9) as a club organized for nonprofit purposes); *Keystone Automobile Club* v. *Commissioner*, 12 T. C. 1038 [Dec. 17,034], aff'd 181 F. 2d 402 (3d Cir. 1950) [50-1 U. S. T. C. ¶ 9266] (claim for exemption under § 101(9)).

Because of our disposition of the exemption phase of the case, it is unnecessary to decide whether the taxpayer has met the additional requirement of § 101(10) that 85 percent of its income was received from members for the sole purpose of meeting losses and expenses.

The taxpayer's general manager testified that its method of establishing this reserve and deferring its income was to prorate 1/12 of the annual dues received in each month of the service membership. In this way, it sought to reserve on its books a part of the taxable year's income to meet obligations to its members (under their membership contracts) which experience presumably had shown would arise in the following year before the expiration of the membership contracts.

Therefore, the income from dues reported by the taxpayer in each of its tax returns for 1947 through 1949 did not include the amount transferred each year to the "reserve for members" account. Contrawise, the taxpayer's annual system of bookkeeping resulted in its including in the income shown on its tax returns for each of the years 1947 through 1949 income from dues which it had actually received in the immediately preceding year.

The Commissioner of Internal Revenue disallowed the taxpayer's deferral of income from one year to another on the ground that advanced payments or prepaid dues received under a claim of right, without restriction as to their disposition, represent income in the year of *receipt* and should be taxed in that year, regardless of the method of accounting used. This position is based on language found in *North American Oil* v. *Burnet*, 286 U. S. 417, 424 (1932) [3 U. S. T. C. ¶ 943], where the Supreme Court said:

> "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return [for tax purposes], even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent."

In *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. 180 [57-1 U. S. T. C. ¶ 9593], rehearing denied, 353

U. S. 989 (1957), the Supreme Court dealt with the same method of treatment of prepaid automobile club membership dues used by the plaintiff in the case at bar.[3] For the reasons stated in *American Automobile Association* v. *United States*, C. Cls. No. 311-58 [60-1 U. S. T. C. ¶ 9301], this day decided, we hold that the Court's decision in *Automobile Club of Michigan* precludes us from overruling the Commissioner's determination that the plaintiff's method of accounting does not clearly reflect income.

The taxpayer, however, has sought to overcome the obstacle posed by the language of the Supreme Court in *Automobile Club of Michigan* by attempting to show that its own pro rata allocation of the membership dues in monthly amounts is not artificial, but that it does, in fact, bear a relation to future demand services, which, it claims, may be predicated with reasonable accuracy. But even if we were to hold that *Automobile Club of Michigan* permitted the plaintiff to make such a showing, we would nevertheless be forced to conclude from an examination of the evidence that the plaintiff's method of accounting does not clearly reflect income.

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[3] The Supreme Court, in affirming the Commissioner's determination that the taxpayer's method of accounting did not clearly reflect income, stated: "The petitioner does not deny that it has the unrestricted use of the dues income in the year of receipt, but contends that its accrual method of accounting clearly reflects its income, and that the Commissioner is therefore bound to accept its method of reporting membership dues. We do not agree. Section 41 of the Internal Revenue Code of 1939 required that '[t]he net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books * * * but * * * if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income * * *.' *The pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member.* Section 41 vests the Commissioner with discretion to determine whether the petitioner's method of accounting clearly reflects income. We cannot say, in the circumstances here, that the discretionary action of the Commissioner, sustained by both the Tax Court and the Court of Appeals, exceeded permissible limits. See *Brown* v. *Helvering*, 291 U. S. 193, 204-205 [4 U. S. T. C. ¶ 1223]." *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. at 189-190. (Italics supplied.)

Using the taxpayer's 1948 tax return as an illustration, we find that the taxpayer has attempted to show that its pro rata allocation in equal monthly amounts reasonably matched actual expenses with the earning of related revenues. It has placed in evidence an exhibit which purports to show that "actual operating expenses" in 1949 relating to or arising out of liabilities or obligations incurred under the 1948 prepaid membership contracts amounted to $53,605.20. In reality, this figure constitutes merely an estimate, which has not been shown to accurately reflect the taxpayer's past experience in servicing its members' contracts. It is merely a computation of the average cost of servicing a member's contract in 1948 multiplied by the over-all percentage (56%) of the membership contracts purportedly extending into the following year.[4] If, as the taxpayer contends, its "actual operating expenses" in 1949 arising out of obligations incurred under the 1948 prepaid membership contracts amounted to $53,605.20, it is difficult to comprehend why it was necessary to defer $85.207.07 of the membership dues collected in 1948 to match these expenses.

Furthermore, the method of obtaining this over-all percentage of the membership contracts extending into the following year is defective. The taxpayer has arrived at this percentage (56%) by not recognizing as income in 1948 the entire amount of prepaid dues collected in December of 1948. Likewise, the percentage of membership contracts extending into the following year (1949) was further increased by the taxpayer's deferral of 1/12 of the amount of the dues received in January of 1948. It is more than obvious, however, that at least some of the dues collected in January and in December, respectively, were earned in

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[4] Cf. *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. at 189; *Bressner Radio, Inc.* v. *Commissioner*, 267 F. 2d 520, 529 (1959) [59-2 U. S. T. C. ¶ 9496].

those two months. If this obvious fact is taken into account the percentage figure would be closer to 52%, rather than 56%. We are forced to conclude that, if the taxpayer's pro rata allocation of the membership dues in equal monthly amounts accurately matches expenses with revenues, it has not been demonstrated here.

[*Pro Rata Allocation.*]

Even if the taxpayer had shown that the pro rata allocation of membership dues in monthly amounts clearly reflects income, it is patent on the facts before us that the taxpayer did not follow this method. The taxpayer's general ledger indicates that the taxpayer received $117,248.14 in membership "dues" in 1948. The ledger also shows that the taxpayer collected $16,613 in "entrance fees" that same year. This latter item apparently covers the $5 application fee which each new member was required to pay in addition to the regular membership dues.[5] The sum of these two items ($117,248.14 plus $16,613) is $133,861.14. It is a part of this sum which the taxpayer treated as income in 1949 (the year a part of this sum was allegedly earned), rather than in 1948 (the year of receipt). Using the taxpayer's percentage figure, it is apparent that no more than $74,962.24 (56% of $133,861.14) should have been deferred in 1948. The taxpayer however, deferred from income $85,207.07 (or approximately 64%) of the membership dues collected in 1948.

But the major fallacy with the taxpayer's method is that a deferral of even 56% (or 52%) of the membership dues collected in 1948 would be artificial and unrealistic. The taxpayer bases its entire position on the premise that under the accrual method earning rather than receipt of payment determines inclusion in gross income, and that the clearest

[5] The taxpayer has not indicated to us any other revenues in 1948 which might be subject to deferral.

reflection of income is obtained by matching, in a given period, expenses and related revenues. Yet the taxpayer has failed to follow its own basic premise.

The very substantial factor which the taxpayer has not taken into consideration in its pro rata allocation of a member's dues in equal monthly amounts is the cost of acquiring the member. The expenses paid or incurred by the taxpayer in 1948 in acquiring members amounted to $33,028. These expenses were deducted entirely in 1948. Since these substantial costs of acquiring members were deducted entirely in 1948, they must, under the accrual concept, be deducted from the total membership dues *prior* to a determination of the amount of the membership dues which are *potentially* unearned in the year of receipt and thereby subject to deferral.[6] Therefore, if the accrual concept is to control, only $100,833.14 ($133,861.14 minus $33,028) could be said to be potentially unearned in 1948 and subject to a possible deferral for inclusion in income in a subsequent year.

The taxpayer, however, in its 1948 return deferred from income $85,207.07 of membership dues collected in that year. This constituted a deferral of approximately 84.5%[7] of that part of the 1948 membership dues which *might* not have been earned in 1948. This method of deferral is unrealistic on its face. The tax returns for the other two years involved in this case, 1947 and 1949, suffer from the same basic defect.

[*Decision.*]

The Commissioner of Internal Revenue is given discretion under § 41 to determine whether the taxpayer's method of accounting clearly reflects income. The discretion

[6] Cf. *Bressner Radio, Inc.* v. *Commissioner*, 267 F. 2d 520 (1959) [59-2 U. S. T. C. ¶ 9496].

[7] Even if only 56% of these acquisition expenses is subtracted from the total of membership dues prior to a determination of the amount of the membership dues which are potentially unearned in the year of receipt, the taxpayer would still have deducted approximately 68% of such dues.

exercised by the Commissioner in this instance did not exceed permissible limits. See *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. 180 (1957) [57-1 U. S. T. C. ¶ 9593].

The plaintiff's petition will be dismissed.

It is so ordered.

FAHY, Circuit Judge, sitting by designation; LITTLETON, Judge (Ret.), and LARAMORE, Judge, concur.

WHITAKER, Judge, concurring:

I concur, but I do so, not only for the reasons stated herein, but for the additional reason stated in my concurring opinion in *American Automobile Club* v. *United States*, No. 311-58 [60-1 U. S. T. C. ¶ 9301], this day decided.

APPENDIX B.

Opinion Below.

American Automobile Association v. *The United States.*

U. S. Court of Claims, No. 311-58, 3/2/60.
[1939 Code Secs. 41 and 42(a)—
similar to 1954 Code Secs. 446 and 451]

OPINION.

JONES, *Chief Judge*, delivered the opinion of the court: The plaintiff, a motor club, seeks to recover Federal income taxes and assessed interest paid for the calendar years 1952 and 1953. The issue to be decided here involves the tax treatment to be accorded the prepaid income of an accrual basis taxpayer. The problem arises because club membership dues are paid to the taxpayer for 12 months in advance.

[*Facts.*]

Plaintiff is a national organization which renders services to affiliated local automobile clubs and their members and performs services of a public nature in fields relating to motoring and travel. In addition to its activities as a national organization the plaintiff operates directly, as divisions, ten local automobile clubs. A substantial portion of the annual gross income of plaintiff is derived from dues, prepaid for one year in advance, received from members of the automobile clubs operated as divisions of the plaintiff.

Plaintiff provides services for the members of the local divisions over the 12-month period following payment of dues. These services, although not completely uniform, generally included the following: (a) A travel service which included trip planning, tour books, accommodation directories, maps and recommended routes; (b) emergency road service which consisted of towing, changing tires, replacing batteries and other minor repairs; the road service

was provided by plaintiff through contracts made with garages and service stations in the areas served by its divisions; (c) bail bond protection up to $5,000 through contracts made by the plaintiff with bondsmen; (d) personal automobile accident insurance; (e) a theft reward offered by the plaintiff for information leading to the arrest and conviction of any person stealing a member's car; (f) in addition, the plaintiff, in one or more of its divisions, provided other personal services for members which included procuring motor licenses, notarial services, brake and headlight adjustments, and advice on how to prepare and file papers in small claims courts.

The prepaid dues collected from members of its divisions were deposited in plaintiff's bank accounts with no restrictions as to their use for any of its corporate purposes. However, the dues upon collection were reflected in a liability account designated "Deferred Revenue—Membership Dues." Thereafter, a pro rata part of the dues was removed from the liability account and reflected in an "income" account. Dues collected from members who joined in the month of January were recognized as income in January only to the extent of 1/24 (a half of 1/12) of such collections, on the assumption that the average or mean date of the January collections would be the middle of the month.[1] Thereafter, 1/12 of the dues collected in January was taken out of the liability account and credited to income in each of the following 11 months (i. e., February through December). The remaining 1/24 of the dues collected in January was kept as a liability in the "Deferred Revenue—Membership Dues" account on December 31, but was subsequently recognized as income for January of the following year.

Dues collected in each of the other months of the calendar year were treated in the same manner. That is, 1/24 of

[1] Plaintiff's taxable year was the calendar year.

each month's collections was recognized as income in the first month of membership, 1/12 of the amount paid was recognized as income in each of the following eleven months, and the remaining 1/24 was allocated to income in the month when membership expired. Commencing in 1954, the plaintiff, in order to simplify internal accounting detail, changed its procedure in the monthly accounting for dues by assigning 50 percent of the dues to income for the current year and allocating the other 50 percent as a liability which matured as income in the following tax year.

In preparing its income tax returns for the years in suit, plaintiff, an accrual basis taxpayer, excluded from the income received in each year that portion of membership dues which remained in the liability account ("Deferred Revenue—Membership Dues") at the end of the taxable year. It thus treated dues as income ratably over the 12-month period of membership, whether or not such period extended beyond the close of its taxable year.

Expenses which plaintiff considered to fall within the category of prepaid membership costs e. g., salesmen's commissions and the cost of accident insurance covering the period of a membership, even though paid by plaintiff, were not deducted entirely in the taxable year paid or incurred, but instead were deducted ratably over the same periods of time that dues were recognized as income.

The income reported by plaintiff in its tax return for the calendar year 1953 attributable to dues received from members of its divisions was $3,337,813.44, representing $1,562,042.23 of prepaid dues collected in 1952 but not recognized as income until 1953, plus $1,775,771.21 of dues collected in 1953 and recognized as income in that year.

For 1954, dues reported by plaintiff as income for purposes of the Federal income tax totaled $3,794,672.20, representing $1,755,407.46 of advance dues collected in 1953 but not recognized as income until 1954, plus $2,039,264.74 of dues collected in 1954 and recognized as income in that year.

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Plaintiff claimed that as a result of a 1954 net operating loss in the amount of $289,967.67, it was entitled to a net operating loss carryback *deduction* in 1952 in the amount of $154,411.11, and a net operating loss carryback *deduction* in 1953 in the amount of $135,556.56. Upon examination of the plaintiff's Federal income tax returns for the calendar years 1952, 1953, and 1954, the Commissioner of Internal Revenue disallowed plaintiff's deferral of income from one year to another, for years subsequent to 1953, thereby increasing plaintiff's 1954 net operating income from $353,279.09 to $481,557.59 and reducing plaintiff's 1954 net operating loss from $289,967.67 to $14,412.49. The net effect of the Commissioner's determination was to reduce plaintiff's net operating loss carryback deduction to $14,412.49 in 1952 and to eliminate entirely any net operating loss carryback deduction in 1953.

[*Issue.*]

The issue to be decided by this court is whether the Commissioner of Internal Revenue correctly determined that plaintiff's method of accounting—with respect to dues received from members of its divisions—does not clearly reflect plaintiff's income within the meaning of § 41 of the Internal Revenue Code of 1939 and § 446 of the Internal Revenue Code of 1954. Section 41 required that "the net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books * * * but * * * if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income * * *"[2]

[2] To the same effect, § 446, Int. Rev. Code of 1954 provides that: "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." However, "if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income."

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[*Claim of Right.*]

The Commissioner of Internal Revenue disallowed the deferral of income from one year to another on the ground that prepaid dues received under a "claim of right," without restriction as to their disposition, represents income in the year of *receipt* and should be taxed in that year regardless of the method of accounting employed by the taxpayer. This position is based on the claim of right doctrine enunciated by the Supreme Court in *North American Oil Co.* v. *Burnet*, 286 U. S. 417, 424 (1932) [3 U. S. T. C. ¶ 943]. It is of course fairly obvious that, once it is determined that prepaid income is required to be included in income in the year of receipt under the claim of right doctrine, it would necessarily follow that any other method of reporting would not "clearly reflect the income."

The opposite view, advanced by the plaintiff—that the claim of right doctrine does not relate to the question whether items that admittedly belong to the taxpayer may be attributed to a taxable year other than that of receipt in accordance with principles of accrual accounting—has been succinctly presented by Mr. Justice Harlan, dissenting in *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. 180, 191-192 (1957) [57-1 U. S. T. C. ¶ 9593].[3]

[*Supreme Court.*]

However, we do not find it necessary to resolve this issue, since we agree with the Government's contention that the method of treatment of prepaid automobile club mem-

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[3] "[The claim of right] doctrine, it seems to me, comes into play only in determining whether the treatment of an item of income should be influenced by the fact that the right to receive or keep it is in dispute; it does not relate to the entirely different question whether items that admittedly belong to the taxpayer may be attributed to a taxable year other than that of receipt in accordance with principles of accrual accounting." (*Automobile Club of Michigan* v. *Commissioner*, 353 U. S. 180, 191-192 (dissenting opinion) (1957) [57-1 U. S. T. C. ¶ 9593].)

bership dues employed by the plaintiff was dealt with by the Supreme Court in *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. 180 [57-1 U. S. T. C. ¶ 9593], rehearing denied, 353 U. S. 989 (1957), and was held to be, at least for Federal income tax purposes, "purely artificial." In the *Automobile Club of Michigan* case prepaid membership dues were credited upon receipt to an account carried as a liability and designated "Unearned Membership Dues." "*During the first month of membership and each of the following eleven months one-twelfth of the amount paid* * * * [was] *credited to an account designated 'Membership Income.'* This method of accounting was followed by petitioner [a motor club] from 1934. The income from such dues reported by petitioner in each of its tax returns for 1943 through 1947 was the amount credited in the year to the 'Membership Income' account." 353 U. S. at 188. (Italics supplied.)

The Commissioner of Internal Revenue had determined that this method of accounting—which is essentially the same method used by the plaintiff in the case at bar—did not clearly reflect income. The Supreme Court, in affirming the action of the Commissioner, stated (353 U. S. at 189-190):

> "The petitioner does not deny that it has the unrestricted use of the dues income in the year of receipt, but contends that its accrual method of accounting clearly reflects its income and that the Commissioner is therefore bound to accept its method of reporting membership dues. We do not agree. * * * *The pro-rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member.* Section 41 vests the Commissioner with discretion to determine whether the petitioner's method of accounting clearly reflects income. We cannot say, in

> the circumstances here, that the discretionary action of the Commissioner, sustained by both the Tax Court and the Court of Appeals, exceeded permissible limits. See *Brown v. Helvering*, 291 U. S. 193, 204-205 [4 U. S. T. C. ¶ 1223]." (Italics supplied.)

Although it would appear that *Automobile Club of Michigan* does not expressly rule out deferral of income,[4] we are constrained to interpret this language as a rejection by the Supreme Court of the accounting method advanced by plaintiff in the case at bar.

We are influenced in our decision by the language used by the Court to distinguish on their facts *Beacon Publishing Co. v. Commissioner*, 218 F. 2d 697 (10th Cir. 1955) [55-1 U. S. T. C. ¶ 9134] (deferral of prepaid magazine subscription income) and *Schuessler v. Commissioner*, 230 F. 2d 722 (5th Cir. 1956) [56-1 U. S. T. C. ¶ 9368] (reserves set up to meet future costs):

> "In *Beacon*, performance of the subscription, in most instances, was, in part, *necessarily* deferred until the publication dates after the tax year. In *Schuessler*, performance of the service agreement required the taxpayer to furnish services at *specified times* in years subsequent to the tax year. In this case [as in the case at bar], substantially all services are performed only upon a *member's* demand and the taxpayer's performance was not related to *fixed dates* after the tax year. We express no opinion upon the correctness of the decisions in *Beacon* or *Schuessler*.[5]"

[4] See *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. at 192-193 (dissenting opinion).

[5] *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. at 189, fn. 20. (Italics supplied.)

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[*Decision*]

But regardless of the underlying basis for the Court's rejection of "the pro rata allocation of the membership dues in monthly amounts" as "purely artificial" we feel constrained by the decision in *Automobile Club of Michigan* to reject that same method of accounting for tax purposes in the case at bar.[6]

The plaintiff is therefore not entitled to recover and its petition will be dismissed.

It is so ordered.

LITTLETON, Judge (Ret.); LARAMORE, Judge, and MADDEN, Judge, concur.

[*Concurring Opinion*]

WHITTAKER, Judge, concurring: From the enactment of the Corporation Excise Tax Act of 1909 and the first income tax act in 1913, it has been universally supposed that in order to "clearly reflect income" the taxpayers' accounting method must treat as gross income amounts received or accrued in the taxable year, with certain exceptions specified in the Code. The income under consideration here was received in plaintiff's taxable year. Plaintiff's method of accounting treats a portion of that income as not having been received in the taxable year and thus does not clearly reflect its income unless it comes within the statutory exceptions. Those exceptions are, for example, reserves for depreciation, obsolescence, and depletion, and, in the case of insurance companies prepaid premium reserves. The statute does not allow the deduction of reserves to anticipate expenses of meeting the demands of plaintiff's membership. What plaintiff, in effect, seeks to do is to deduct such a reserve from the income it received within the taxable year.

I also concur in the majority opinion.

[6] Cf. *Bressner Radio, Inc.* v. *Commissioner*, 267 F. 2d 520, 528-529 (2d Cir. 1959) [59-2 U. S. T. C. ¶ 9496]; *Automobile Club of Southern California* v. *United States*, Civil No. 1169-58, S. D. Cal., January 22, 1960 [60-1 U. S. T. C. ¶ 9274].